

Multiple Monetary Policy Instruments, Foreign Exchange Intervention, and Exchange Rate in China

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Summary

This paper investigates the effects of monetary and foreign exchange policies on the exchange rate in China. In the empirical model, a multiple number of monetary and foreign exchange policy instruments, such as the short-term interest rate, reserve requirement ratio, lending and borrowing rates, and foreign exchange intervention, are considered to describe Chinese monetary and foreign exchange policy properly. In addition, the interactions among these instruments and their interactions with the exchange rate are modelled carefully to analyze the effects of monetary and foreign exchange policies on the exchange rate properly.

The main findings are as follows. First, (contractionary) monetary policy shocks lead to the exchange rate appreciation, which is statistically significant. It is particularly interesting that shocks to all popular monetary policy instruments, such as the short-term interest rate, reserve requirement ratio, lending and borrowing rates, have significant effects on exchange rate.

Second, shocks to foreign exchange interventions have limited effects on the exchange rate. Shocks to foreign exchange interventions have significant effect on the exchange rate in the short-run at best, but not in the long run. Even a persistent (or permanent) foreign exchange intervention has a temporary

effect on exchange rate. In addition, a temporary foreign exchange intervention does not have any significant effect on exchange rate.

Sterilisation is likely to explain the limited effect of foreign exchange intervention on the exchange rate. The trend of exchange rate movements may mostly be determined by economic fundamentals, not by foreign exchange intervention, especially sterilised one. The presence of capital controls might be related to the weak effect.